United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

ORIGINAL

75-7030

United States Court of Appeals

For the Second Circuit

Docket No. 75-7030

FRIGITEMP CORP., GERALD LEE, GERALD ROSS, HENRY GUTMAN and LEON GUTTMAN,

Plaintiffs-Appellants,

against

FINANCIAL DYNAMICS FUND, INC., FINANCIAL INDUSTRIAL FUND, INC., FINANCIAL VENTURE FUND, INC., FINANCIAL PROGRAMS, INC., ROBERT E. ANTON and JOHN M. BUTLER,

Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF PLAINTIFFS-APPELLANTS

BLACKMAN LEFRAK FELD & FISCHER
Attorneys for Plaintiffs-Appellants
424 Madison Avenue
New York, New York 10017
(212) 421-7633

GERALD D. FISCHER
LLOYD D. FELD
of Counsel

TABLE OF CONTENTS

The Issues Presented for Review 1

Statement of the Case 2

Statement of the Facts 5

ARGUMENT

I—Frigitemp may maintain an action at common law and under Section 10(b) of the Securities Exchange Act of 1934 against defendants who purchased 74% of Frigitemp's publicly held shares using material inside information obtained in a private placement 7

A. The First Cause of Action of the Complaint States a Claim by Frigitemp for Common Law Fraud 7

B. The Second Cause of Action of the Complaint States a Claim on Behalf of Frigitemp Under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 Thereunder 15

II—The individual plaintiffs may maintain an action under Section 10(b) and at common law against defendants who caused them to relinquish 100,000 shares of Frigitemp stock without disclosing that they were cornering the market in Frigitemp's shares using material inside information 20

A. The Third Cause of Action of the Complaint States a Claim on Behalf of the Individual Plaintiffs for Violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 Thereunder 20

PAGE

B. The Fourth Cause of Action of the Complaint States a Claim for Relief on Behalf of the Individual Plaintiffs for Common Law Fraud 25

CONCLUSION 26

TABLE OF AUTHORITIES

Cases

Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) 21, 23

Bank v. Board of Educ. of City of New York, 305 N.Y. 119, 133 (1953) 25

Birdman v. Electro-Catheter Corp., 352 F. Supp. 1271 (E.D. Pa. 1973) 24

Brophy v. Cities Serv. Co., 31 Del. Ch. 241 .....9, 10, 11

Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961) 14

Chasins v. Smith, Barney & Co., 438 F. 2d 1167 (2d Cir. 1971) 22, 23

Crane v. Westinghouse Air Brake Co., 419 F. 2d 787 (2d Cir. 1969) *cert. denied*, 400 U.S. 822 (1972) .. 23

Davidge v. White, 377 F. Supp. 1084 (S.D.N.Y. 1974) 10, 11

Diamond v. Oreamuno, 24 N.Y. 2d 494, 301 N.Y.S. 2d 78 (1969) 7, 10, 11, 13

Donovan v. Aeolian Co., 270 N.Y. 267, 271 (1936) .. 25

Drachman v. Harvey, 453 F. 2d 722 (2d Cir. 1972) .. 18

PAGE

Dutton v. Willner, 52 N.Y. 312, 319 8

Fisher v. Bishop, 108 N.Y. 25, 15 N.E. 331 25

Gildenhorn v. Lums, Inc., 335 F. Supp. 329 (S.D.N.Y. 1971), rev'd *on other grounds sub nom, Schein* v. *Chasen*, 478 F. 2d 817 (2d Cir. 1973), *vacated on other grounds*, 94 Sup. Ct. 1741 (1974) 7

Jeffries & Co., Inc. v. Arkus Duntov, 357 F. Supp. 1206 (S.D.N.Y. 1973) 24

Matter of People [Bond & Mtge. Guar. Co.] 303 N.Y. 423, 431 8

Rothmiller v. Stein, 143 N.Y. 581. 38 N.E. 718 (1894) 25

Shapiro v. Merrill Lynch Pierce Fenner & Smith, Inc., 353 F. Supp. 264 (S.D.N.Y. 1972), aff'd 495 F. 2d 228 (2d Cir. 1974) 12

Schein v. Chasen, 478 F. 2d 817 (2d Cir. 1973), *vacated on other grounds* 94 Sup. Ct. 1741 (1974) 7, 10, 11, 19

Shell v. Hensley, 430 F. 2d 819, 827 (5th Cir. 1970) .. 18

Schlik v. Penn-Dixie Cement Corp., 507 F. 2d 374 (2d Cir. 1974) 18

SEC v. Texas, Gulf Sulphur Co., 446 F. 2d 1301 (2d Cir. 1971) *cert. denied*, 404 U.S. 1005 (1972) 13

Steinberg v. Guild, 254 N.Y.S. 2d 4, 22 A.D. 2d 775 (1st Dept. 1964) *aff'd* 262 N.Y.S. 2d 715, 16 N.Y. 2d 791 (1965) *remittitur amended* 265 N.Y.S. 2d 107, 16 N.Y. 2d 960 25

Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 12 (1971) 17, 22

Wendt v. Fischer, 243 N.Y. 439, 433 8

PAGE

Statutes and Rules

Securities and Exchange Act of 1934, Section 10(b), 15 U.S.C. § 78j(b) ..... 3, 4, 7, 15 *passim*

Securities Act of 1933, Section 17(a), 15 U.S.C. § 77q (a) 3

Rule 10b-5, 17 C.F.R. § 240, 10b-5 ..... 3, 15, 16, 17 *passim*

Federal Rules of Civil Procedure Rule 12(b)(6) 3, 5

Miscellaneous

Restatement, 2d Agency (§ 388, Comment *c*) 9

United States Court of Appeals

For the Second Circuit

Docket No. 75-7030

FRIGITEMP CORP., GERALD LEE, GERALD ROSS, HENRY GUTMAN and LEON GUTTMAN,

Plaintiffs-Appellants,

against

FINANCIAL DYNAMICS FUND, INC., FINANCIAL INDUSTRIAL FUND, INC., FINANCIAL VENTURE FUND, INC., FINANCIAL PROGRAMS, INC., ROBERT E. ANTON and JOHN M. BUTLER,

Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF PLAINTIFFS-APPELLANTS

The Issues Presented for Review

1. Can a New York corporation maintain an action for common law and Section 10(b) fraud against defendants who purchase 74% of the corporation's publicly held shares on the basis of material inside information obtained by the defendants in a private placement in which they failed to disclose their scheme?

2. Can the individual plaintiffs who were required by the defendants to contribute 100,000 shares to the capital

of the plaintiff corporation as a condition of the private placement maintain an action for common law and Section 10(b) fraud against the defendants who failed to disclose to them their scheme to acquire 74% of the plaintiff corporation's publicly held shares on the basis of material inside information?

Statement of the Case

This action was brought by Frigitemp Corp. ("Frigitemp") and the individual plaintiffs, shareholders of Frigitemp, against three mutual funds, Financial Venture Fund, Inc. ("FVF"), Financial Industrial Fund, Inc., and Financial Dynamics Fund, Inc. (collectively referred to as "the Funds"), their investment advisor, Financial Programs, Inc., and Robert E. Anton and John M. Butler, officers of the defendant corporations. The complaint alleges that defendants engaged in a fraudulent and manipulative scheme to corner the market in Frigitemp's common stock while in possession of material, non-public and confidential inside information acquired in connection with a private placement of Frigitemp's securities (A4-11a). Specifically, between March 1969 and March 1970, the Funds purchased 74% of the common stock of Frigitemp then available to be traded publicly. Shortly after the open market purchases began, defendant FVF purchased from Frigitemp, in a private transaction, a $1,000,000 convertible subordinated debenture and warrants to purchase 50,000 shares of Frigitemp's common stock ("the private placement"). In connection with this transaction the defendants acquired material inside information and used that information in buying up all but a small part of the public float of Frigitemp's common stock.

Frigitemp sues to recover defendants' profits and for punitive damages and alleges claims at common law and

under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78 j (b), and Rule 10b-5, 17 C.F.R. § 240.10 b-5, promulgated thereunder.*

The individual plaintiffs sue to recover the value of 100,000 shares of Frigitemp common stock which the defendants required them to contribute to the capital of Frigitemp as a condition of the private placement. Defendants are accused of common law fraud and violation of Section 10(b) in failing to disclose to the individual plaintiffs (i) that they were in the process of acquiring all but a small part of Frigitemp's public float and (ii) that the material and inside information obtained by them in the private placement would be used to carry forward their scheme to corner the market.

On December 5, 1974, Honorable Charles H. Tenney granted defendants' motion to dismiss all four claims of the complaint pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure (A188a). Plaintiffs now appeal from the final order and judgment of dismissal (A200a).

In dismissing Frigitemp's claim for common law fraud, Judge Tenney ruled that persons who are not officers or directors and who acquire, in confidence, material and inside information, and exploit that information to their profit, must disgorge the profits to the corporation only if those persons "are 'co-venturers' of a fiduciary of the corporation, engaged with the fiduciary in a 'common enterprise' to misuse confidential corporate information" (A192a). Judge Tenney thus concluded, contrary to existing authority, that Frigitemp could not maintain an action at common law for misuse of material and inside information because the defendants were not alleged to be fiduciaries or "to have acted in concert with a fiduciary of Frigitemp" (A192a).

---

* Claims alleged by the plaintiffs under § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a) have been abandoned.

Judge Tenney dismissed Frigitemp's claim for relief under § 10(b) of the Securities Exchange Act of 1934 on the grounds that it was not a seller of securities (A192a). In doing so, he disregarded the fact that the material inside information misused by the defendants was obtained by them in connection with Frigitemp's sale to one of the Funds of a debenture and warrants. Judge Tenney thus incorrectly concluded that a corporation which has been fraudulently induced to disclose material and inside information in connection with a sale by it of its securities may not sue for damages resulting from misuse of that information.

Judge Tenney also dismissed the claims of the individual plaintiffs for common law fraud and for violation of § 10(b) (A193-197a). The individual plaintiffs had been required by the defendants to contribute 100,000 of their shares of Frigitemp to its capital as a condition for the purchase by the defendant FVF from Frigitemp of its debenture and warrants. Judge Tenney held that the defendants are not liable to those plaintiffs for failing to disclose to them (i) that the Funds were in the process of cornering the market in Frigitemp's stock, (ii) that the material inside information made available to the defendants in connection with the private placement would be used by the Funds in carrying forward their massive stock acquisition program and (iii) that the Funds had a direct financial interest in the contribution of 100,000 shares to Frigitemp's capital since the Funds were a substantial owner of Frigitemp's shares and would be the prime beneficiary of said contribution.

Judge Tenney's conclusions as to the common law and § 10(b) claims of Frigitemp and the individual plaintiffs are directly contrary to the controlling authorities and establish a dangerous precedent.

Statement of the Facts

The complaint, as supplemented by the affidavits submitted in opposition to defendants' motions to dismiss pursuant to Federal Rule 12(b)6, describes defendants' fraudulent and manipulative scheme:

In January 1969, Frigitemp initially sold its securities to the public in an offering consisting of 80,000 shares of common stock and warrants to purchase and debentures convertible into another 100,000 shares (A6a).

Without the knowledge of plaintiff Frigitemp or the individual plaintiffs (A140a), and commencing in March 1969, the Funds began their open-market purchases of Frigitemp's common stock. Between March 1969 and March 1970, the Funds acquired 142,100 shares, or approximately 74% of the shares of common stock of Frigitemp then available to be traded by the public (A6a; 141-142a). As a result of the Funds' purchases, the market price of Frigitemp's common stock more than doubled from $15.25 to a high of $37 per share in March 1970 (A7a; 151-170a).

Shortly after the Funds began their open market purchases and in or about June 1969, Frigitemp met with various of the defendants to discuss a possible private placement of Frigitemp securities (A136-138a). Thereafter, and on or about August 29, 1969, defendant FVF purchased from Frigitemp for $1,000,000 Frigitemp's 5% convertible subordinated debenture in that amount and warrants to purchase 50,000 shares of common stock (A7a). In connection with that transaction and as a condition thereof defendants required plaintiffs Gerald Lee, Gerald Ross, Henry Guttman and Leon Guttman, who were officers or employees of Frigitemp, to contribute to the capital of Frigitemp an aggregate of 100,000 of their shares, thereby reducing

defendants who caused them to relinquish 100,000

Frigitemp's outstanding shares and immediately increasing the earnings and book value per share of the remaining outstanding shares (A20a).

Between June and August 1969, as part of the discussions leading to the private placement, and in the debenture agreement itself, the defendants obtained from Frigitemp material inside information,* which, unbeknown to the plaintiffs, was thereafter used by the defendants in furtherance of their scheme to corner the market in Frigitemp's common stock (A9a; 140-142a; 150a).

Plaintiffs first learned of defendants' wrongful market manipulation in 1971 (A140-142a), by which time the Funds had dumped almost all of their Frigitemp stock (A144a) and had driven the market price down to $5 per share (A151-170a). During the period of time covered by the Funds' purchases, Frigitemp's common stock reached a high price of $37 per share in March 1970 when the Funds stopped their purchases (A151-170a; 150a). They sold out all of their shares throughout 1970 and up to April, 1971 (A40-41a). As their sales were made, the stock declined, as rapidly as it had risen, to a price of under $5 by the end of 1970 (A151-170a).

---

* For purposes of the motion to dismiss, defendants did not dispute the allegations that they were furnished with material inside information, which information is set forth in detail in the complaint (A7-9a) and in the affidavit of Gerald Lee submitted in opposition to defendants' motion to dismiss (A137-139a).

inside information, they were in the process of acquiring

ARGUMENT

POINT I

Frigitemp may maintain an action at common law and under Section 10(b) of the Securities Exchange Act of 1934 against defendants who purchased 74% of Frigitemp's publicly traded shares using material inside information obtained in a private placement.

A. The First Cause of Action of The Complaint States A Claim by Frigitemp for Common Law Fraud

The first cause of action of the complaint alleges that the defendants perpetrated a common law fraud against Frigitemp by breaching a duty of trust owed to it. The claim is based upon the defendants' cornering the market and manipulating the price of Frigitemp's shares and using material inside information in connection with the Funds' purchases, thereby undermining the market for, and impairing the public acceptance and marketability of, Frigitemp's shares.

The first cause of action states a claim under the common law of New York, the state of Frigitemp's incorporation (A4a).* The New York Court of Appeals case of *Diamond* v. *Oreamuno*, 24 N.Y. 2d 494, 301 N.Y.S. 2d 78 (1969) is in point. There, the court held that persons who acquired non-public information by virtue of a confidential relationship were not free to exploit that information for personal profit and must account to the corporation

---

* Under the New York choice of law rules, the law of the state of incorporation determines the existence and extent of corporate fiduciary obligations and liability. *Diamond* v. *Oreamuno*, 24 N.Y. 2d 494, 301 N.Y.S. 2d 78 (1969); *Gildenhorn* v. *Lums, Inc.*, 335 F. Supp. 329 (S.D.N.Y. 1971) *rev'd on other grounds sub nom, Schein* v. *Chasen*, 478 F. 2d 817 (2d Cir. 1973), *vacated on other grounds*, 94 Sup. Ct. 1741 (1974).

for their profits even if the corporation itself had suffered no specific damages. The court stated (24 N.Y. 2d at 498):

> "It is true that the complaint before us does not contain any allegation of damages to the corporation but this has never been considered to be an essential requirement for a cause of action founded on a breach of fiduciary duty. (See, e.g., *Matter of People* [*Bond & Mtge. Guar. Co.*] 303 N.Y. 423, 431; *Wendt* v. *Fischer*, 243 N.Y. 439, 443; *Dutton* v. *Willner*, 52 N.Y. 312, 319.) This is because the function of such an action, unlike an ordinary tort or contract case, is not merely to *compensate* the plaintiff for wrongs committed by the defendant but, as this court declared many years ago (*Dutton* v. *Willner*, 52 N.Y. 312, 319, *supra*), 'to *prevent* them, by removing from agents and trustees all inducement to attempt dealing for their own benefit in matters which they have undertaken for others, or to which their agency or trust relates.' (Emphasis Supplied.)"

The Court pointed out that a corporation suffers substantial damages by the wrongful trading in its securities based upon inside information (24 N.Y. 2d at 499):

> "In addition, it is pertinent to observe that, despite the lack of any specific allegation of damage, it may well be inferred that the defendants' actions might have caused some harm to the enterprise. Although the corporation may have little concern with the day-to-day transactions in its shares, it has a great interest in maintaining a reputation of integrity, an image of probity, for its management and in insuring the continued public acceptance and marketability of its stock. When officers and direc-

> tors abuse their position in order to gain personal profits, the effect may be to cast a cloud on the corporation's name, injure stockholder relations and undermine public regard for the corporation's securities."

The New York Court of Appeals relied upon the following authority in support of its holding that a corporation could maintain an action against those who trade its securities on the basis of inside information (24 N.Y. 2d at 500-501) (emphasis added):

> "In *Brophy* v. *Cities Serv. Co.* (31 Del. Ch. 241, *supra*), for example, the Chancery Court of Delaware allowed a similar remedy in a situation not covered by the Federal legislation. One of the defendants in that case was an employee who had acquired inside information that the corporate plaintiff was about to enter the market and purchase its own shares. On the basis of this confidential information, the employee, *who was not an officer* and, hence, not liable under Federal law, bought a large block of shares and, after the corporation's purchase had caused the price to rise, resold them at a profit. The court sustained the complaint in a derivative action brought for an accounting, stating that '[*p*]*ublic policy will not permit an employee occupying a position of trust and confidence toward his employer to abuse that relation to his own profit*, regardless of whether his employer suffers a loss' (31 Del. Ch., at p. 246). And a similar view has been expressed in the Restatement, 2d, Agency (§ 388, Comment *c*)."

It should be noted that in the *Brophy* case, which was relied upon by the court in *Diamond* v. *Oreamuno*, the defendant was a mere employee who abused the confidence placed in him by his employer.

In *Schein* v. *Chasen*, 478 F.2d 817 (2d Cir. 1973), *vacated on other grounds*, 94 Sup. Ct. 1741 (1974), this Court extended the principle of *Diamond* v. *Oreamuno* to hold liable to the corporation persons who were neither officers, directors or employees but who were involved with directors in a scheme to misuse confidential corporate information. In holding these persons liable to the corporation, this Court stated (478 F.2d at 822):

> "We find nothing in the language of *Diamond* to suggest that co-venturers of the director who breaches his duty should not be subject to the same liabilities as those of the director himself for the misuse of corporate information."

The principles of *Diamond* and *Schein* were further extended in *Davidge* v. *White*, 377 F. Supp. 1084, (S.D.N.Y., 1974). There, the court refused to dismiss a claim by a corporation against a former officer and director for trading on inside information after he was no longer an officer or director. The court stated (377 F. Supp. at 1089-90) (emphasis added):

> "[M]ost important, it would be illogical to hold that one who gains confidential information by virtue of his fiduciary capacity, and thereby incurs a fiduciary duty not to profit from such information, is absolved of this duty on the day after his formal resignation as director. *As long as the information upon which the defendant, as former insider, is trading, remains confidential or undisclosed to the public, the defendant, as we read Delaware law has a duty not to personally profit from this information.*"

• • •

> "*The common law violation lies* not simply in the keeping of confidential information but rather *in the making of personal profit as a result of being privy to such information.*"

When read together, the decisions in *Diamond, Schein* and *Davidge* establish the principle that anyone who, in confidence, obtains material inside information is duty bound not to profit therefrom.

Judge Tenney narrowly interpreted the *Diamond* and *Schein* decisions as holding that

> "persons who are not officers or directors of a corporation may be held liable to the corporation for profits made if they are co-venturers of a fiduciary of the corporation, engaged with the fiduciary in a 'common enterprise' to misuse confidential corporate information". (A 192a)

and that

> "Since defendants are not alleged to be fiduciaries of Frigitemp and since they are not alleged to have acted in concert with a fiduciary of Frigitemp, the theory of liability set forth in *Diamond* and *Schein* would not permit Frigitemp to recover any profits defendants may have made." (A192a)

Judge Tenney's conclusions are an unduly restrictive interpretation of the principles established in *Diamond* and *Schein*.

In *Brophy* v. *Cities Serv. Co., supra*, cited with approval in *Diamond*, the defendant was neither an officer or a director of the corporation. In *Davidge* v. *White, supra*, the defendant was not an officer or director when his trading wronged the corporation. In each case, defendants' liability was imposed because of the position of trust they

occupied by reason of the confidential information imparted to them and not by reason of their status as officers or directors.

Even though the defendants in this case were not officers or directors of Frigitemp, they were taken into Frigitemp's confidence and entrusted with material inside information in connection with the private placement. Defendants thereby acquired the relationship of trust and confidence to Frigitemp of a fiduciary and are answerable for trading on the confidential information imparted to them.

The special responsibilities of a financial institution in its dealings with a corporation in a financing transaction are described in *Shapiro* v. *Merrill Lynch Pierce Fenner & Smith, Inc.*, 353 F. Supp. 264 (S.D.N.Y. 1972), *aff'd* 495 F. 2d 228 (2d Cir. 1974). In that case a financial institution was held liable for misusing confidential information furnished to it by a corporation in connection with an issue of securities it was underwriting for that corporation. In reaching that decision, the court there stated (353 F. Supp. at 273):

> "This Court finds that, under the allegations of fact contained in the complaint, plaintiffs have demonstrated the required scienter. Defendant Merrill Lynch was acting in a confidential capacity as managing underwriter of the Douglas bond issue when it received the information. It knew the information was the exclusive property of Douglas. The individual defendants, as employees of Merrill Lynch, were aware of this special relationship and knew, or should have known, of the confidential nature of the information. The selling defendants were likewise aware, or should have been aware, of the confidential nature of both Merrill Lynch's

> relationship with Douglas and the information. The sequence of events alleged in the complaint, and the materiality of the information, ineluctably leads to the conclusion that all defendants acted with the knowledge that buyers of Douglas stock on the NYSE would not be in possession of such material information and, hence, acted with the intent to take advantage of that ignorance."

In *SEC* v. *Texas Gulf Sulphur Co.*, 446 F. 2d 1301 (2d Cir. 1971) *cert. denied*, 404 U.S. 1005 (1972) this Court applied the New York common law principles of *Diamond* v. *Oreamuno* to award to the corporation the profits derived from the misuse of inside information by persons other than its officers and directors. In that case, the Court stated, (446 F. 2d at 1308):

> "Finally, appellants contend that the order is punitive because it contains no element of compensation to those who have been damaged. However, as the New York Court of Appeals in Diamond v. Oreamuno, 24 N.Y. 2d 494, 499, 301 N.Y.S. 2d 78, 81-82, 248 N.E. 2d 910, 912-913 (1969), recognized, a corporate enterprise may well suffer harm 'when officers and directors abuse their position to obtain personal profits' since 'the effect may be to cast a cloud on the corporation's name, injure stockholder relations and undermine public regard for the corporation's securities.' Although the sellers of TGS stock who sold before April 17, 1964, may have a higher equity that [than] TGS to recover from appellants the wrongful profits appellants obtained, this fact does not preclude conditional compensation to TGS. Nor, as the appellants appear to imply, is the district court precluded from applying a state concept of harm to the corporation."

It is thus apparent that an insider need not be an officer, director or controlling stockholder, but can be anyone who, by virtue of his position, is in possession of confidential information. The Securities and Exchange Commission in *Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961) stated the controlling principles of insider liability as follows (emphasis added):

> "We have already noted that the anti-fraud provisions are phrased in terms of 'any person' and that a special obligation has been traditionally required of corporation insiders, e.g., officers, directors and controlling stockholders. These three groups, however, do not exhaust the classes of persons upon whom there is such an obligation. Analytically, the obligation *rests on two principal elements: first, the existence of a relationship giving access, directly or indirectly, to information intended—to be available only for a corporate purpose and not for the personal benefit of anyone*, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. In considering these elements under the broad language of the anti-fraud provisions *we are not to be circumscribed by fine distinctions and rigid classifications. Thus our task is to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities.*"

For a legitimate corporate purpose, and to effect a private placement of its securities, Frigitemp disclosed to the defendants material non-public and confidential information, both prior to the private placement and in the very agreement of the sale of the securities (A136-139a).

The defendants used the information furnished to them in connection with the Funds' open market purchases of Frigitemp's shares. Under the authorities cited above, the defendants should be required to disgorge all profits which they obtained in connection with their trading in Frigitemp's stock, regardless of any losses they may have subsequently incurred.

The decision below, if permitted to stand, would allow any person, who was not an officer or director, to trade on material inside information, disclosed to him in confidence, so long as he was not engaged in a common enterprise with the officer or director who furnished that information. Should Frigitemp be denied a remedy against the defendants because its officers and directors did not participate in the defendants' fraudulent scheme? Frigitemp was damaged by the defendants' unlawful conduct. The integrity of the market for its securities was no less impaired because the wrongful trading was done by persons other than its officers or directors. Accordingly, Frigitemp should not, we submit, be without a remedy for the wrongs occasioned by the defendants abuse of the confidence which had been reposed in them.

B. The Second Cause of Action of the Complaint States a Claim on Behalf of Frigitemp Under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder

Frigitemp's second cause of action is brought under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

Section 10(b), designed to prevent unfair advantage being taken of anyone in a securities transaction, makes it unlawful:

> "To use or employ, in connection with the purchase or sale of any security registered on a national

securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5, promulgated thereunder, provides:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security."

Frigitemp contends that the defendants' cornering of the market in Frigitemp stock and the misuse of material inside information in connection therewith is a violation of § 10(b) for which it can sue. Moreover, the failure of the defendants to disclose to Frigitemp, at the time of the private placement, that the Funds had purchased substantial amounts of Frigitemp's shares and would use the confidential information to purchase 74% of Frigitemp stock available to be traded publicly, constituted a fraudulent non-disclosure of a material fact under Rule 10b-5.

Judge Tenney dismissed Frigitemp's § 10(b) claim "on the grounds that Frigitemp was not a purchaser or seller of its securities during March 1969 through March 1970." (A192-193a). He totally disregarded the sale by Frigitemp of its $1,000,000 debenture and warrants to defendant FVF and the wrongful use of the inside information disclosed to the defendants in connection with that sale.

The purchase of the debenture and warrants was an integral part of the fraud perpetrated upon Frigitemp. The information imparted to the defendants in connection with that purchase and sale was employed by them in their fraudulent and manipulative scheme. It was this scheme that caused Frigitemp to be damaged and of which it complains.

A number of recent decisions have held that where defendants engage in a fraudulent scheme and the purchase and sale of a security is part of that scheme, a cause of action is stated under section 10(b) and Rule 10b-5. Thus, in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), the United States Supreme Court held that a seller of securities could recover under § 10(b) and Rule 10b-5 from a participant in a scheme to misappropriate the proceeds of the sale. The Court stated (404 U.S. at 12-13) (emphasis added):

> "Section 10(b) must be read flexibly not technically and restrictively. Since there was a 'sale' of a security and since fraud was used 'in connection with' it there is redress under Section 10(b). . . ."

and

> "The crux of the present case is that [the defrauded party] suffered an injury as a result of deceptive practices *touching its sales of securities* as an investor."

The Court quoted with approval the following from *Shell* v. *Hensley*, 430 F.2d 819, 827 (5th Cir. 1970):

> "When a person who is dealing with a corporation in a securities transaction denies the corporation's directors access to material information known to him, the corporation is disabled from availing itself of an informed judgment on the part of its board regarding the merits of the transaction. In this situation the private right of action recognized under Rule 10b-5 is available as a remedy for the corporate disability."

Following the authority of the *Bankers Life* decision this Court has held in *Drachman* v. *Harvey*, 453 F. 2d 722 (2d Cir. 1972), that a corporation could recover damages suffered by it as a result of an improvident redemption of its debentures which its controlling stockholders and directors caused it to make in order to assure continuation of their control of the corporation, even though the redemption itself was free of fraud.

Recently in *Schlik* v. *Penn-Dixie Cement Corp.*, 507 F. 2d 374 (2d Cir. 1974) this Court sustained a claim under § 10(b) for losses suffered upon an exchange of shares pursuant to a merger where the exchange ratio was adversely affected by manipulation by the acquiring corporation of the market price of the acquired corporation's stock, even though the exchange itself was not fraudulent. In finding that the manipulation was sufficiently "in connection with" a purchase and sale the Court stated it was unnecessary that the purchase and sale be the immediate cause of the loss. Instead this Court held the complaint to be sufficient if (507 F. 2d at 381):

> "It alleges a specific scheme to defraud . . . the fraud was accomplished in connection with a securi-

> ties transaction; the appellant was a seller in that transaction; and as a result of the sale, appellant alleges a loss was sustained."

The complaint in this action alleges (a) that the defendants engaged in a fraudulent and manipulative scheme to corner the market in Frigitemp's shares; (b) that in connection therewith, the defendants fraudulently obtained inside information furnished by Frigitemp in connection with a purchase of a debenture and warrants, without disclosing their intention to use said information to carry forward their scheme; and (c) as a result of this fraud and manipulation, the defendants adversely affected the integrity of the trading market for Frigitemp's shares, to Frigitemp's substantial damage. Accordingly, Frigitemp alleges a fraud and manipulation by defendant's "in connection with" the purchase and sale of a security to its damage and states a claim under § 10(b) and Rule 10b-5.

Finally, defendants contended below that they should not be required to disgorge the profits they realized in 1970. They urged, instead, that Frigitemp should be barred from recovery since the Funds' 1971 losses far exceed their 1970 profits. But to do equity, and to effectuate the purposes and policy of the securities laws, the defendants should be required to pay over their 1970 profits, regardless of the Funds' losses in subsequent years. The purpose of the rules discussed above is to "provide a disincentive to insider trading." (*Schein* v. *Chasen*, *supra*, at p. 823). To permit the defendants to set-off the losses which the Funds may have subsequently incurred would not be in accord with this purpose. The defendants inflicted damage upon Frigitemp. No benefit inured to Frigitemp when the Funds dumped their shares one and two years later. Having artificially inflated the prices of Frigitemp's stock and having been unable to maintain the stock at those prices the Funds should not be permitted to benefit by offsetting their self-inflicted losses.

POINT II

The individual plaintiffs may maintain an action under Section 10(b) and at common law against defendants who caused them to relinquish 100,000 shares of Frigitemp stock without disclosing that they were cornering the market in Frigitemp's shares using material inside information.

A. The Third Cause of Action of the Complaint States a Claim on Behalf of the Individual Plaintiffs for Violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 Thereunder

The individual plaintiffs, who were induced to contribute 100,000 of their shares to Frigitemp's capital in connection with Frigitemp's private placement with defendant FVF, are defrauded sellers under Section 10(b) and Rule 10b-5. Their claim is based upon the defendants' failure to disclose to them (a) that the Funds had purchased and would continue to purchase 142,100 shares, or approximately 74%, of the publicly held shares of Frigitemp, (b) that in connection with these open market purchases, the defendants used and would continue to use the material inside information furnished to them by Frigitemp in connection with the private placement, and (c) that the defendants' purpose in causing the individual plaintiffs to contribute 100,000 shares to Frigitemp's capital was to increase the market value of the shares that the Funds wrongfully had acquired and were continuing to acquire by reason of the immediate increase in the earnings and book value per share of the shares of Frigitemp remaining outstanding. Accordingly, the third cause of action seeks damages of $21 per share, the market value of the shares contributed.

The undisputed facts alleged in the complaint (A6-11a), *which relate to all of the causes of action,* together with those furnished by affidavits are as follows:

1. Between June and August 1969, in connection with the private placement, the defendants acquired material

inside information relating to the business and affairs of Frigitemp (A7-9a; 137-139a).

2. At the time the defendants acquired said material inside information, they were in the process of acquiring 74% of Frigitemp's public float (A6a; 9a; 141a).

3. At the time the defendants required the individual plaintiffs to contribute their 100,000 shares to the capital of Frigitemp, the defendants failed to disclose (a) the past open market purchases by the Funds, (b) their intention to continue these purchases and to corner and manipulate the market; (c) their intention to wrongfully use the material inside information obtained in the private placement; and (d) the direct financial benefit to them of the contribution of the 100,000 shares by the individual plaintiffs (A140-142a).

Judge Tenney, in dismissing this claim, totally disregarded these facts. He concluded that the defendants did not have to disclose to the individual plaintiffs either the Funds' past or intended purchases or the defendants' market manipulation even though such information would have been material to the plaintiffs' decision to contribute their shares.

The Court's decision below is thus directly contrary to the existing authorities which recognize a duty of a purchaser of securities to disclose to the seller information which may not directly relate to the corporation's internal affairs but which is material to the sellers' investment decision.

In *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972), the Supreme Court held that the failure by buyers of securities to disclose to sellers of securities information concerning the buyers' purchases of and the market for such securities constituted violations of Section

10(b) and Rule 10b-5. In that case employees of a transfer agent had failed to disclose to sellers of securities (a) purchases for their own account, (b) the existence of another market for the securities of which the sellers were unaware, and (c) commissions and gratuities they received from traders in that other market. The Supreme Court found that the employees of the transfer agent were liable to the sellers under Section 10(b) and Rule 10b-5 not only on account of their own purchases and sales but for their failure to disclose to the sellers the existence of and facts relating to the other market. The Court stated (406 U.S. at 153):

> "These defendants' activities, outlined above, disclose, within the very language of one or the other of those subparagraphs, a 'course of business' or a 'device, scheme or artifice' that operated as a fraud upon the Indian sellers. *Superintendent of Insurance* v. *Bankers Life & Casualty Co.* . . . This is so because the defendants devised a plan and induced the mixed-blood holders of UDC stock to dispose of their shares without disclosing to them material facts that reasonably could have been expected to influence their decisions to sell. The individual defendants, in a distinct sense, were market makers, not only for their personal purchases comprising 8⅓% of the sales, but for the other sales their activities produced. This being so, they possessed the affirmative duty under the Rule to disclose this fact to the mixed-blood sellers. See *Chasins* v. *Smith, Barney and Co.* . . . It is no answer to urge that, as to some of the petitioners, these defendants may have made no positive representations or recommendations. The defendants may not stand mute while they facilitate the mixed-bloods' sales to those seeking to profit in the non-Indian market the defendants

> had developed and encouraged and with which they were fully familiar. The sellers had the right to know that the defendants were in a position to gain financially from their sales and that their shares were selling for a higher price in that market."

In *Chasins* v. *Smith, Barney & Co.*, 438 F. 2d 1167 (2d Cir. 1971), cited with approval by the Supreme Court in *Affiliated Ute*, a broker had failed to disclose that it was making a market in securities, the purchase of which it had recommended to a customer. In holding the failure to disclose the broker's financial interest a violation of Section 10(b) and Rule 10b-5 the Court stated (438 F. 2d at 1172):

> "Knowledge of the additional fact of market making by Smith, Barney in the three securities recommended could well influence the decision of a client in Chasens' position, depending on the broker-dealer's undertaking to analyze and advise, whether to follow its recommendation to buy the securities; disclosure of the fact would indicate the possibility of adverse interests which might be reflected in Smith, Barney's recommendations."

and

> * * *
>
> "In this situation failure to inform the customer fully of its possible conflict of interest, in that it was a market maker in the securities which it strongly recommended for purchase by him, was an omission of material fact in violation of Rule 10b-5, 17 C.F.R. 240, 10b-5".

In *Crane* v. *Westinghouse Air Brake Co.*, 419 F. 2d 787 (2d Cir. 1969) *cert. denied*, 400 U.S. 822 (1972) this Court held the failure to disclose the artificial inflation of the market price of a corporation's shares was a violation of § 10(b) and Rule 10b-5.

Similarly, in *Jeffries & Co., Inc.* v. *Arkus Duntov*, 357 F. Supp. 1206 (S.D.N.Y. 1973) and *Birdman* v. *Electro-Catheter Corp.*, 352 F. Supp. 1271 (E.D.Pa. 1973) non-disclosure of material information that did not relate to the internal affairs of the Corporation was held to be actionable under Section 10(b) and Rule 10b-5.

In the instant case, the defendants failed to disclose (a) their scheme to corner the market in Frigitemp's stock using material inside information and (b) the financial benefit that would inure to the Funds upon the contribution by the plaintiffs of 100,000 of their shares to Frigitemp's capital. Had they made these disclosures, the individual plaintiffs' determinations concerning this contribution assuredly would have been different. The individual plaintiffs, being substantial shareholders of Frigitemp, undeniably were motivated by a desire to help Frigitemp and all of its shareholders. However, they had no motivation to give consideration to the defendants in addition to the securities being issued to FVF by Frigitemp in the private placement.

The failure of the defendants to disclose to the individual plaintiffs their manipulative scheme thus prevented the individual plaintiffs from relinquishing their 100,000 shares with all material information in their possession. Had the individual plaintiffs known of the Funds' scheme, it must be assumed that, as fiduciaries of Frigitemp, they would have been duty bound to refrain from making any disclosures to the defendants and from entering into the transaction. The individual plaintiffs would thus not have contributed their shares of Frigitemp to their financial detriment.

B. The Fourth Cause of Action of the Complaint States a Claim for Relief on Behalf of the Individual Plaintiffs For Common Law Fraud

The common law of New York recognizes claims for fraud based upon intentional concealment of material facts. See, e.g., *Steinberg* v. *Guild*, 254 N.Y.S. 2d 4, 22 A.D. 2d 775 (1st Dept. 1964) *aff'd.* 262 N.Y.S. 2d 715, 16 N.Y. 2d 791 (1965) *remittur amended* 265 N.Y.S. 2d 107, 16 N.Y. 2d 960; *Bank* v. *Board of Educ. of City of New York*, 305 N.Y. 119, 133 (1953); *Donovan* v. *Aeolian Co.*, 270 N.Y. 267, 271 (1936).

Judge Tenney dismissed this claim by concluding that plaintiffs relied only upon nondisclosures of a material fact and that defendants had no duty to speak. But as Judge Tenney himself admits the Funds "entered into a special relationship" with Frigitemp upon receiving non-public information in connection with the private placement. Under the laws of New York an abuse of a confidential relationship is actionable. Moreover, it is the duty of a person in whom confidence has been reposed by virtue of a confidential or fiduciary relationship to make a full disclosure of all material facts relating to a contemplated transaction with the other party to such relationship and any failure to disclose such facts is a fraud. *Rothmiller* v. *Stein*, 143 N.Y. 581, 38 N.E. 718 (1894); *Fisher* v. *Bishop*, 108 N.Y. 25, 15 N.E. 331; *Steinberg* v. *Guild*, *supra*. Here, plaintiffs conveyed material inside information to the defendants in confidence and trust and the defendants betrayed that confidence. Having obtained the inside information and having caused the individual plaintiffs to relinquish 100,000 shares, defendants thereupon misused the confidence which had been reposed in them by going into the open market and buying up Frigitemp's common stock. Under these circumstances, we submit, defendants were obligated to disclose to

the plaintiffs the extent of their holdings at the time of the private placement and to further disclose their intentions with respect to future purchases. Only by such disclosure could the individual plaintiffs intelligently determine whether or not to contribute their 100,000 shares to Frigitemp.

CONCLUSION

For the reasons stated above the decision of the District Court should be reversed.

Dated: New York, New York
March 21, 1975

Respectfully submitted,

BLACKMAN LEFRAK FELD & FISCHER
Attorneys for Plaintiffs-Appellants
424 Madison Avenue
New York, New York 10017
(212) 421-7633

GERALD D. FISCHER
LLOYD D. FELD
of Counsel

Service of ~~three (3)~~ (2) copies of the within
is hereby admitted
this 21st day of March, 1975

BUTOWSKY, SCHWENKE & DEVINE

Attorney(s) for E Mikalis
2:50 pm

Service of ~~three (3)~~ (2) copies of the within
is hereby admitted
this 21st day of March, 1975

~~Attorney(s) for~~
Attorneys for Richard Stapleton, Peggy
A Holmes, attorneys for defendant